NOTES

DESIGNATION OF PROPRIETARY INTERESTS IN THE BALANCE SHEET

The subject of accounting, which for a long time was looked at askance and treated as a stepchild among courses in economics, has now come to be rather generally recognized as essential to the training of an economist, entirely aside from its place in business training. Courses in accounting now appear on the schedules of departments of economics in most of our universities and colleges. The reason for this is that economists have come to recognize that almost any kind of study of the working of economic forces in the business world of today requires, among other things, an understanding of (1) the manner in which the status of a business investment is commonly set forth, (2) the facts to be considered in determining the successfulness of a business investment, and its status at a given time, and (3) the type of information needed by the business manager as an aid in controlling the investment, and the methods by which such information may be gathered.

But in spite of the growing recognition of the need for an understanding of these matters by the economist, it is still easy to find evidence in the writings, public addresses, and classroom utterances of some economists of high standing that these men have not given sufficiently careful consideration to the nature of a business investment and the manner in which it should be stated. Thus to the instructor in accounting it seems rather unfortunate to have the student assured by the instructor in an earlier course in economics that the capital stock and surplus of the corporation, or the capital account of the single proprietor or partner, is a liability of the business, or at least in the nature of a liability. Such a statement must inevitably have the effect of confusing the student in his thinking on the nature of business investment.

It is likely, however, that the blame for this erroneous conception is to be laid at the door of the practicing accountants, a large number of whom continue the traditional practice of presenting the balance sheet of a business in the "account" form, the left side being headed "Assets," and the right side "Liabilities." Nearly all of these accountants know better, but like the members of most of the professions, they are over-conservative, and given to a too close following of precedent. This

is particularly true with regard to the balance sheets of banks, which are published more frequently than those of other types of business concerns, and therefore exert more influence on the lay mind.

That the amount which represents the interest of the owner or the owning group is not a liability of the business in the legal sense of the term is quite evident, since it clearly lacks two important essentials of a liability. Thus it is (1) not payable at any specified time, and (2) it is not enforceable by law. The fact that the law recognizes a clear distinction here scarcely needs to be proved or discussed at length. But the way in which the terms are employed, and the use of the form of balance sheet mentioned above, in which no attempt is made to distinguish proprietorship from liabilities, would indicate that many consider the legal distinction a meaningless one in so far as the real nature of things is concerned.

The attitude just indicated scarcely seems to be justified by the facts. It is quite true that the concept of ownership has changed very greatly since the legal distinction between liabilities and proprietorship was first established. The old concept is well exemplified today, of course, in the single-proprietor enterprise and in the partnership. Here the owner, after paying off all claims of creditors, can, within certain broad limits, do about as he pleases with the remaining assets. In the modern corporation, the stockholders as a group have theoretically very much the same sort of rights over the net assets of the corporation, but in practice it appears that there are often a number of classes of stockholders, with marked differences existing in the nature of the rights attaching to the ownership of each class. Just as all liabilities must be met out of the fund of assets before the owning group can have any claim in the final distribution of this fund, so certain classes of stock are preferred to others in the final division of assets, as well as in the distribution of income. Also, the rights of a holder of a non-cumulative and non-participating preferred stock without voting power are not easy to differentiate from the rights of the holder of an income bond, though the first is classed as proprietorship and the other as liability.

Even in the extreme case just cited, however (and neither of the securities here mentioned is of a type that is often found), there is a distinction which justifies their being classed separately. The stockholder is one of a group, each member of which assumes a share of the risk of the undertaking. And even when it is not earning sufficient income to allow of the distribution of any to the stockholders, and when it is plain that a liquidation of the assets would mean the loss of a part or all

of the stockholders' investment, there is always the chance for continuation and for the ultimate success of the undertaking under its current management, so long as the equities of the creditors are protected and their current claims satisfied. The bondholder or other creditor may, if he is willing, assume a risk as regards the income he is to receive from the company, but if his principal is threatened through lack of sufficient assets to protect his equity, he may call on the courts to take steps to protect his interests. This may result in a liquidation and dissolution of the corporation, or it may lead to a reorganization, with a resulting readjustment of the various claims.

For this reason, if for no other, the significance of these two claims is different, both from the standpoint of the manager of the business and from that of its creditors. The status of the business enterprise is not correctly represented, either as to the investment of the owning group or as to the security of the creditors' claims, when the balance sheet fails to show a separation between the claims of the owning group and the claims of its creditors.

The fiction that the amount of the interest of the proprietor or proprietary group is in the nature of a liability of the business to the members of this group is one which probably arose out of the inability of bookkeepers to explain why the balances of liability accounts and those of proprietary accounts both appear on the same side of the ledger. The explanation for this, however, is not difficult. Since the total of the balances of the proprietary accounts represent the difference between the total of the asset balances and the balances of the liability accounts, the total of liability balances and proprietorship balances together equals the total of the asset balances. By showing additions to proprietorship on the same side of the ledger as additions to liabilities, therefore, a balance is maintained, and double-entry bookkeeping thereby made possible. This misapprehension with regard to the nature of proprietorship will doubtless disappear when accountants universally follow the practice of showing the items whose total represents the net proprietorship of the owning group as a separate group on the balance sheet, under an appropriate heading. This is done now by many of the best accounting firms, but is far from being a common practice.

An interesting commentary on this matter is that while the banks continue to issue their statements showing "Assets" balancing with "Liabilities," various associations of bankers require their customers to report the status of their business investments on forms which provide

for the subtraction of liabilities from assets, and for the showing of the result thus obtained, not as another type of liability, but as Net Worth, or Proprietorship. The men who prepared these forms were led through their desire for definite, intelligible information to forsake the "balance" fetish, and to provide for a sane and logical reporting of the facts concerning the investment of the owners in the business enterprise.

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COAL PRODUCTION AND THE STRIKE SETTLEMENT

There is to be a respite in the bituminous coal controversy—a commission is to be appointed which will presumably arrange terms of settlement for wages. But it will be only a respite unless, besides patching up a truce on the wages issue, we take advantage of the breathing space thus afforded to do some fundamental thinking on the whole economic situation of the coal industry and to take measures to put the industry on a more satisfactory footing. A mere wage compromise will settle nothing. The fundamental need of the industry is more regular and more efficient production, and the first step is to have some competent body turn the light on the technical and economic facts of the industry in the search for possibilities of improvement. This work demands the services of expert engineers and men familiar with the mining and commercial sides of the coal business, but the inquiry should be in the control of disinterested persons.

The typical "hard-headed" attitude toward proposals of this type is to the effect that there is not much promise in appointing somebody to tell somebody else how to run his business more efficiently than he does already. If people do somthing that looks inefficient there is generally a reason, and it is generally the case that the removal of such apparent wastes would be more expensive than the wastes themselves. One may grant the prima facie force of this argument, though the vogue of the efficiency expert proves that it does not tell the whole story. But in the present case there are definite economic reasons why certain efficiency measures might well be profitable for the industry as a whole or for the nation as a whole, even if they do not appear profitable after the fashion of calculation of employers in general and of the mine operators in particular. And there are possibilities of arranging that the mine operators should find it profitable to carry out efficiency measures which at present they figure do not pay. The present note aims to present a working hypothesis in support of this claim.